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**COMMENTS OF TURN ON EMISSIONS ALLOWANCE
DISTRIBUTION UNDER POTENTIAL CAP AND TRADE
REGULATION**



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COMMENTS OF TURN ON EMISSIONS ALLOWANCE DISTRIBUTION UNDER POTENTIAL CAP AND TRADE REGULATION

Pursuant to the schedule adopted in the Administrative Law Judges' Ruling of October 15, 2007 (ALJ Ruling), The Utility Reform Network provides these responses to the various questions raised in the ALJ Ruling concerning "policy issues related to the distribution of emission allowances if a cap and trade system is adopted."

Given the premise of adoption of a "cap and trade" system,¹ TURN generally recommends allowance auctioning, especially if the Commission ultimately recommends that the point of regulation be generators and first sellers. However, TURN strongly cautions that the Commission must carefully weigh the relative merits of load-based versus first seller regulation, and the Commission should recommend appropriate measures be taken to ensure that auction revenues collected from bundled IOU customers should benefit ratepayers as rate reductions or by funding existing legislatively mandated programs designed to reduce greenhouse gas (GHG) emissions, such as the California Solar Initiative, renewables and energy efficiency programs funded through the public goods charge. The Commission must strongly urge the ARB and the legislature to recognize that utilities do not face the same incentives as unregulated market participants, and ratepayer funding of programs represents the most regressive form of taxation.

¹ A carbon tax appears to have a greater potential for fairness, and would likely be preferred by TURN. However, that option has been omitted from the range of proposals considered here.

INTRODUCTION AND GENERAL COMMENTS

The Ruling asks parties to provide detailed comments concerning the distribution of carbon emissions allowances in the electric sector, assuming the existence of a future cap-and-trade market compliance mechanism under AB 32, by an auction or by administrative allocation. The questions ask whether the recommendations concerning the distribution method depends upon the type of regulation ultimately adopted – load-based versus first seller. TURN at this point is agnostic with regard to the value of a carbon market. Given that greenhouse gas issues and global warming are arguably evidence of a huge market failure, reliance on a market mechanism as part of the solution requires a leap of faith. However, facing a choice of how to pursue a “cap and trade” mechanism, a carbon fee (here, “auctioning”) which changes relative prices and captures the revenue for public use and for ratepayers in particular, provides the more equitable approach to the use of market-based incentives.

Before answering the specific questions, TURN addresses several issues that we believe should be further examined prior to making a final decision on auctioning versus administrative allocation.

The Commission originally determined it would administratively allocate allowances using a “load based cap.”² Under ‘load based’ (LB) regulation the Commission would regulate the emissions of the total energy purchases of a load serving entity. Load serving entities are within the jurisdiction of the Commission. LB regulation

² See, D.06-02-032, Ordering Paragraph 2. See, also, ACR in R.06-04-009, February 2, 2007, discussing intent to adopt “general guidelines for a load-based emissions cap that could be applied by the CPUC and CARB to all electricity sector entities that serve end-use customers in California.”

minimizes emissions “leakage,” which could occur if the Commission regulated only in-state generators, who could evade such regulation by choosing to site higher carbon merchant plants out of California.

On June 30, 2007 the Governor’s Market Advisory Committee (MAC) issued its “Recommendations for Designing a Greenhouse Gas Cap-And-Trade System for California” (MAC Report), and recommended that the State adopt a ‘first seller’ (FS) approach, where the point of regulation is in-state generators and the first seller of imported power. The MAC argued that the FS approach likewise resolved the leakage issue and provided a better fit for any future potential regional or national regulation. The Commission modified this rulemaking in response to the MAC Report³ and requested that parties file comments and reply comments concerning the MAC Report in August of 2007.⁴

Numerous parties pointed out in their comments that the FS approach causes generators to internalize the costs of emissions in bid prices and thus raises wholesale electric prices. During the en banc meeting concerning GHG regulation, Bruce Biewald of Synapse Energy presented results from a simplified model showing that because increased marginal bids result in a higher Market Clearing Price for all power, the increase in wholesale prices has a multiplicative impact on the total cost of power by including the allowance cost for all power at the MCP irrespective of its actual carbon emissions profile. Mr. Biewald calculated that a \$30/ton carbon allowance price, which represents an additional cost of approximately \$300 million per year for all energy

³ D.07-07-018, *mimeo.* p. 4.

⁴ TURN did not file comments with the CPUC in August of 2007.

consumed in the state based on net carbon emissions, would increase annual wholesale power costs by two to four ***billion dollars*** due to its impact on the market clearing price in the wholesale market.

Several commentators responded by criticizing the assumptions and conclusions of the Synapse model. Mr. Biewald agreed that the model had some simplifying assumptions, such as that all power was produced by merchant plants. Commission ratemaking would not in reality allow “extra” revenues from utility-owned hydroelectric or nuclear power to flow to shareholders.

The primary response to Mr. Biewald’s analysis appear to be the argument that even if carbon costs are not explicitly internalized in the wholesale market under a LB approach, all generators will include the carbon cost, essentially as an opportunity cost, in their bids.

TURN is extremely concerned about the potential impacts of FS regulation on the wholesale market. It seems that this is an issue that would benefit from additional theoretical and mathematical analysis. Given the huge potential impact on California wholesale energy costs and resulting retail rates, TURN strongly urges the CPUC to address this issue directly. This is not an issue that the CPUC should punt to the ARB. The CPUC is in the best position to provide guidance on the financial repercussions of FS versus LB regulation.

TURN does not claim to have the answer at this time. We strongly urge the Commission to set an additional workshop and develop an expedited process to address this issue. If necessary, we urge the Commission to order Staff or a consultant to conduct

additional modeling on the impact of FS versus LB on wholesale prices and resulting retail rates.

TURN also urges the Commission to consider the implications of the current hybrid market for generation, where the utilities both own generation assets and also compete for developing new generation. TURN's underlying preference for auction under first seller regulation is based on the assumption that an auction provides for an economically efficient allocation of allowances, minimizes over-procurement (or over-allocation) by any entity purely for speculative purposes, and ensures that the value of the allowances gets captured for public use to reduce rates and/or reduce carbon emissions.

However, even in the context of first seller, the financial incentives for IOUs may be different than for merchant generators and may skew the efficiency gains due to an auction and lead to increased ratepayer costs. Regulated IOUs can flow through all allowance costs to ratepayers. Any competitive pressure to lower costs depends greatly upon the as-yet undetermined future market structure.

There is one last, but most important, issue that is unique to the regulated power sector. California ratepayers, and particularly bundled customers of the regulated utilities, already spend over **one billion dollars a year** to fund various statutory and regulatory directives to increase renewable energy purchasing (RPS), fund significant energy efficiency activities, support distributed generation (SGIP), support rooftop photovoltaics (CSI) and solar water heating, and perhaps fund research concerning global warming.

There will undoubtedly be considerable pressure to use auction revenues to further support programs designed to reduce global warming. The Commission should clearly and forcefully acknowledge that utility ratepayers have been contributing more

than their share to these efforts, and that a large portion of auction revenues must be used to offset the costs of existing programs. Moreover, it is not at all clear that additional haphazard funding for such programs would be most cost-effective. For example, supply bottlenecks may make additional investments in renewable energy impractical in the short term.⁵ Funding for GHG reduction should start with a thorough review and comparison of existing programs to provide some coordination and effective prioritization. For example, it is no secret that the biggest contributor of carbon emissions in the electric sector is the use of imported coal. An equitable portion of revenues could be used to deliberately wean portions of California off out-of-state coal.

This issue of capturing public revenue, addressed in question 8, is a critical one for consumers and will presumably be extensively discussed in future proceedings, as well as at the Legislature. The question of mitigation of costs to consumers, and providing social and public benefits from auction proceeds, underlies all of TURN's subsequent comments. ***We support auctioning or carbon fees only on the assumption that the revenues from carbon auctions will be equitably and appropriately allocated.*** We urge the Commission to recommend measures that will ensure that auction proceeds are either returned to ratepayers, used to subsidize rates for vulnerable low-income customers, and/or used to offset the costs of existing programs designed to lower GHG emissions, as discussed further in response to question 8.

⁵ There is currently a shortage of materials and vital parts (for example, wind turbines, silicon for PV) preventing a rapid short term increase in renewable project installation.

RESPONSES TO SPECIFIC QUESTIONS

Evaluation Criteria

Question 1. MAC Criteria

These criteria are consistent with AB 32, which specifically references authority for an emissions fee (Section 38597) to use for the purposes of carrying out the “division,” that is, controlling GHG emissions. Throughout AB 32, there are references to environmental justice concerns, equity and fairness, and economic considerations, which are reflected in these criteria. In fact, the presumption of a cap-and-trade system which informed the Market Advisory Committee is a presumption not specifically contained in AB 32, and in our view the MAC inappropriately limited the full scope of exploration of market-based incentives only to cap-and-trade. That said, their work product was thoughtful and thorough.

TURN participated in the MAC process itself, and these criteria are not only reasonable but specifically point to the conclusion that MAC reached, that is, that an auction meets these reasonable criteria better than administrative allocation.

Our comments on each of these criteria are as follows:

a. Impact on consumers, particularly low-income. This issue is one of major concern to TURN. On the one hand, the transition to a lower carbon-emitting economy will inevitably involve costs in a variety of forms, including the costs of carbon permit fees collected via an auction. On the other, the revenues from a carbon auction must mitigate the effects of increased carbon fees both for low-income people and communities, and for consumers generally, for whom frugal use of electricity is part of

the solution. It is important to note that lower-income consumers are likely to have lower carbon emissions due to lower than average energy use, yet are most burdened by electricity and transportation fuel costs.

b. Avoids windfall profits. This criterion creates the appropriate framework for consideration of the issue of auction versus allocation. In the European Trading System, those to whom credits were allocated reaped substantial windfalls, while consumer prices rose in any case. We should note that this criterion was incorporated in the State of California's message on federal policy.⁶ Thus, as a matter of state policy, this criterion has already been acknowledged.

c. Promotes low-GHG using technology. The purpose of any market trading system is to alter the relative prices of using lower rather than higher carbon-emitting approaches for the same output. While regulatory approaches under consideration by the ARB are an important part of technology shifts, the change in relative prices is the primary benefit of a market-based system, one which by operation of price signals would promote low-GHG technology. As discussed below, administrative allocation rather than auction can actually reward the wrong technology.

d. Overburdened communities. The important environmental justice concern becomes part of the overall way of distributing costs and benefits which, among other approaches, can be promoted in a market trading system by tight definition of offsets. That is, to the extent that credits or offsets are part of a market-based system, offsets can

⁶ "As indicated by several academic studies as well as the recent experience in the European Union's Emissions Trading System, freely allocating allowances can lead to large windfall profits by providing emitters with allowances whose value greatly exceeds their compliance costs." State of California, Recommendations for Federal Climate Policy.

be directed on a priority basis to overburdened communities. However, any cap and trade system is prone to harming overburdened communities if GHG emissions and attendant contaminant emissions are locally more concentrated as a result of allowance trading.

e. Mitigates dislocation from out-of-state competition. While there may be differential cost impacts to generators depending on whether emissions are auctioned or allocated, to the extent such costs are internalized in wholesale prices and given that both FS and LB minimize “leakage,” there should be less dislocation due to competition from out-of-state generators. TURN notes that any single-state regulation, including that of GHG emissions, raises concerns that economic activity (in other energy consuming sectors) may be exported due to higher energy costs. Minimizing such concerns is another reason to use auction revenues to offset costs of existing GHG reduction programs.

f. Avoids perverse incentives. This criterion speaks in large part to the incentive to stockpile emissions in anticipation of a free grandfathering process. It also speaks to the question of rewarding early action, not discouraging it. As the state’s official recommendations for federal policy notes, “Free distribution based solely on historical emissions will only serve to reward the biggest polluters at the expense of consumers and penalize early leadership.”⁷ Thus, this type of perverse incentive has already been correctly addressed by the state.

g. Provides transition assistance to displaced workers. The question of costs and economic dislocation will undoubtedly have to be addressed. While studies have anticipated economic benefits as well as costs, those are not distributed evenly, such that

⁷ Ibid.

dislocations will need to be addressed. The availability of revenues from auction provides a means by which this might reasonably be accomplished.

h. Market liquidity. Given the concentration of both electricity and transportation fuels, there is a very real need to consider the implications of market concentration. But market liquidity may be less important, to the extent that all actors have the incentive to buy only the bare minimum number of allowances that are necessary. If purchases have been minimized, then the trading market could be relatively thin, and it becomes an equilibrating mechanism, not the driver of the program. In any case, market liquidity probably requires the inclusion of transportation fuels as well as electricity.

With regard to priorities, the impacts on consumers, the avoidance of windfalls and mitigation of impacts on overburdened communities are TURN's primary concerns.

Basic Options for Auction versus Administrative Allocation

Q2: Auction or Allocation⁸

Assuming a deliverer/first seller approach, the most effective policy is 100% auction of all permits, combined with equitable distribution of the revenues to mitigate adverse impacts on consumers, including lower-income people in particular. (A load-based approach would likely take a different approach—see below). This approach is premised on the notion that consumers and/or the public effectively “own the sky”⁹ as a public good, and that the public auctions off the permits to emit carbon, in ever-declining quantities consistent with AB 32.

⁸ TURN specifically addresses only the electricity sector in these responses.

⁹ See Peter Barnes, “Who Owns the Sky: Our common assets and the Future of Capitalism”, 2003, for the origins of this phrase.

100 % auction meets many of the criteria above. It changes relative prices among higher- and lower-GHG emitting power plants and technologies, advantaging the cleaner plants and technologies. It avoids administrative determination of credits for early adopters, by rewarding early adoption through the market mechanism (i.e. requires purchasing fewer credits, such that early adoption is its own reward and is encouraged from the moment an auctioning system is announced). It avoids the windfalls of allocating free allowances to large polluters. It follows the basic environmental principle of “polluter pays.” It is administratively far simpler, such that generators/first sellers determine how many permits to buy, and how to minimize their costs of buying permits. And it establishes a stake in the market, by which those with something to trade have purchased something of value. The Commission should be highly skeptical on any claim that a market can work appropriately if the allowances are distributed for free.

For the electricity sector, auctioning changes the relative desirability of advanced technologies versus legacy technologies, renewable technologies versus fossil fuels. Over time, the question of the impact on electricity prices requires careful monitoring. There are likely to be a variety of countervailing pressures on prices, and rates will need to carefully give greater incentives to pursue conservation, as they do now. The use of revenues from auction with regard to rate impacts will be a critical concern, requiring close scrutiny at both the Legislature which, under section 38597, has authority over proceeds from fees, and at the PUC, to the extent to which the PUC is given authority in this area.

While TURN recommends that 100% of the allowances be auctioned under a first-seller/generator approach, an administrative allocation is likely preferable under a

load-based approach. Under a LB approach the allowances essentially represent the cap for each LSE. The LSE should monetize its allowance costs.

Q3: Partial auctioning: While we recommend 100% auctioning, some MAC participants made the case that polluters can be made whole by 80% auctioning, and others have argued for transitional policies. Our expectation is that the ability to single out those companies or sectors (e.g. cement) eligible for partially free allowances will be based on political influence, not rational decision-making. To the extent there is a strong case, relative to inequity or economic dislocation caused by auctioning, that same case can be made with regard to use of revenues. That is, the revenues can mitigate the particular case at hand. In that case, however, other competing claims of the public will be heard more powerfully for the general use of those revenues, and the results are likely to be more consistent with need than political influence in the free allocation process, where the stakes are less transparent.

Q4. Consistent with the comments above, community aggregators and other entrants into the electricity market should be required to purchase their allowances like all other market participants. Such a policy would create an incentive for those new entrants to minimize their GHG emissions, which is precisely how a market is supposed to work. To the extent that the auction is further upstream, this may not be an issue, except in the price structure facing the market entrant. That is, a community aggregator purchasing only renewables would likely pay no carbon charges at all.

Allocation by Auction

Q5-Q9. Auction design

TURN offers the following general comments on this set of questions.

While this proceeding focuses only on emissions allocation in the energy (gas and electric) sector, the most effective auction program will be the one with the deepest market—that is, one which is not restricted by sector but includes transportation fuels as well. With regard to design, it is our view at this point that “Program 4” in the MAC report is likely to be the fairest, most comprehensive and effective, and easiest to administer, should an auction or cap and trade system move forward. We would question a program which was limited to electricity and natural gas only, or which structured trading only by sector. Rather, carbon auction and trading should take place for all carbon allowances, which itself would create a more liquid market.

Program 4 covers all CO₂ emissions, on an “upstream” basis, which would require purchasing allowances and/or fees as fossil fuels enter the stream of commerce. It would cover 83% of emissions, and would involve approximately 1/10 of the points of regulation required by downstream programs. Costs may or may not be shifted downstream, depending on whether competitors with fewer emissions can enter the market and force permit fee costs back to the emitter. That is a consumer advantage. For example, costs imposed at the wellhead in California do not pass through to California consumers. To the extent that substitutions take place, not all auction costs for fossil fuels will be passed through to consumers.

The question (Q7) of market power becomes an issue in this scenario. In our view, auctioning permits in the transportation sector is a rough equivalent of a carbon tax,

because it cannot be avoided unless fuel consumption drops as the emissions cap drops, or as alternative fuels replace fossil fuels. In the first seller/generator approach, the payment is for the fossil fuel, which discourages consumption and promotes efficiency and conservation. To the extent that this approach functions as a carbon fee, market power issues do not arise. However, since an auction essentially sets an indeterminate level of fee, market power can easily become an issue in terms of initial price setting. To the extent that participants have to pay for their initial allowances, and the program is implemented initially through a fee which serves as a price floor, the trading market may end up being a secondary concern. That is, it is our recommendation that the ARB begin the process of creating a market by setting a permit fee initially, which would serve as the price floor in an auction. A price floor would also give purchasers of allowances assurance that the market will not collapse, as it did in Europe.

With respect to Q5 (design principles), we offer the following criteria as principles to consider in the design of auctions:

- Transparency
- Open participation
- State agency oversight for market monitoring
- Structural flexibility
- Cost minimization

As we mention below, the United States has very limited experience with auctions of environmental attributes. Applying the experiences from the EU for carbon allowances

or those in the US for electricity is instructive, but we advocate for an approach that does not lock California into a specific structure or a design which is difficult to change. We would suggest that the Commission consider adapting the “incorporation by reference” administrative procedures into its rulemaking for auctions. This enables the basic structure to be known and subject to public review, but it does not burden the Commission with extensive regulatory requirements and procedures for minor changes.

Auctions and procedures that guide them should encourage transparency to enable certainty, credibility and confidence. Transparency also helps with price discovery and market monitoring. Some, especially generators under a FS approach, may express concern that data should be kept confidential so as to avoid “reverse engineering” by potential competitors. This is a red herring, since much of these so-called confidential data are already required to be public, such as emissions from individual generating units and hourly prices in the electricity markets. Concerns may also be expressed that auctions should be closed to avoid allowance hoarding by sellers, and to give the affected sources the first option to buy them. This is another red herring. Even if a closed structure was preferred, there is no guarantee, and in fact no one would know initially, if one generator or more had paired with a hedge fund to help them secure allowances. There is broad agreement, across the spectrum from affected sources to brokers to hedge funds, that there is going to be a secondary market regardless of how California or other states establish their greenhouse gas programs. So, requiring auctions to be conducted openly enables robust and liquid market behavior, and helps the appropriate state, consumer and other interested parties to conduct oversight.

With regard to structural flexibility, we would simply offer here that whatever program design the Commission ultimately chooses, the rules and procedures associated with its implementation be written in ways that can be adjusted based on feedback and market monitoring. We would also recommend that the Commission describe the type of feedback mechanisms it intends to use to assess the efficacy of the chosen auction design to meet the stated program criteria.

And last but not least, the Commission should opt for the approach that minimizes costs to California consumers where practicable.

Q6: Timing and frequency of auctions

There is little actual experience to date with auctions in environmental programs. TURN's position for auctioning allowances is informed by studies from Germany and the UK that conclude that providing allowances free to generators has resulted in windfall profits. Ireland has auctioned about 5% of its EU carbon allowances, and in the United States, the State of Virginia auctioned a small percentage of its NOx allowances as part of that state's NOx budget program.

Based on this very limited experience to date, we believe that the framework to auction California allowances should be flexible, especially in the initial years, and nimble in order to adjust to observed or unexpected market behavior. Initially, auctions should be conducted at a frequency of once per quarter for at least the first two years. Dispersing tranches of allowances more frequently enables discovery of carbon price, effective oversight by regulatory agencies and advocacy groups and builds confidence and certainty in the market. More frequent auctions also enables participants, sellers and

oversight agencies to adjust more readily to situations where not all the allowances offered for bid are sold (i.e. some of the allowances could be withheld or not all may be purchased) and to price volatility. The latter could be triggered by several factors, whether due to poor business decisions (as were seen in the Southern California RECLAIM program), hedging by companies that are unsure of their long-term portfolio needs¹⁰ or by brokerage firms purchasing large amounts of allowances for resale on the secondary market.

The actual calendar date that the auctions occur should be linked to complement existing California programs. Generators, for example, are required to provide CEM¹¹ data to the state and federal EPA each quarter. Sources covered by Title V permits under the Clean Air Act are required to report their compliance status every six months. Since there is a time lag associated with data quality assurance, the auction date should occur around day 135 rather than day 90 (using January 1st as day 1 in this example). Since these data are also publicly available, having this explicit linkage also helps improve transparency. Obviously, after a couple of auctions, this design principle is less critical. On the other hand, if the date of the auction coincides with that when other data, such as those mentioned above, are due, market participants and oversight agencies will have to

¹⁰ This relates to market design. Affected sources or load serving entities will base their behavior on the relevant compliance period. A three year compliance period may produce different results than a one year period. For non-base loaded generators, where capacity factors differ from year to year, some may decide to run frequently in one year (say to take advantage of high market clearing prices during peak demand periods), and less so in a following year (say if it is cooler than normal). Load serving entities may also adjust portfolios depending upon the lengths of the various contracts they assemble.

¹¹ Continuous emissions monitors. Required under the Clean Air Act for all electric generating units larger than 25 MW. The Act also specifies data quality assurance and control procedures.

review data that is six or nine months old rather than three. So, offsetting the auction date slightly, as suggested here, can help to assure that the auction behavior is guided by the freshest data and information.

Q8: Distribution of Revenues.

The success or failure of this program from a consumer perspective depends on the effectiveness and equity of distribution of revenues. Beginning with the perspective that the public owns the sky and the rights to pollute, what process can best advance the cause of GHG control and provide fairness and equity to the public? Legally and practically this issue will be decided by the legislature—legally, pursuant to section 38597, which provides that the legislature expend the proceeds of carbon permit fees, and practically, because the issue is one which calls out for resolution by elected representatives.

Nevertheless, the CPUC can significantly influence this outcome by recommending that auction proceeds be used to offset the significant contributions of utility ratepayers to fund statutorily prescribed carbon reduction strategies. The Commission should advocate that auction revenue proceeds should be used to fund programs currently funded through rates, so as to prevent inexorable rate increases that disproportionately hurt low-income bundled utility customers.¹² The Commission could alternatively advocate for structural mechanisms to ensure that GHG reduction is not disproportionately funded by the most regressive form of taxation – through utility rates.

¹² In light of the recent report calculating a \$70,000 annual cost for a family of four to meet its basic needs in many parts of California, as well as the less than 100% enrollment of eligible customers in CARE programs, the notion that the lower rates available to customers enrolled in utility CARE programs sufficiently protects low-income customers is misplaced and inadequate.

There will undoubtedly be strong interest from the legislature and other stakeholders to use auction proceeds to fund additional GHG reduction programs. TURN views the revenues from auction as a more transparent way to pay for above-market costs of emissions reductions strategies. These revenues, however, should be used to replace some or all of the current numerous GHG-related charges already included in utility rates. California utility customers, and especially bundled ratepayers of the regulated utilities, already spend over one billion dollars per year on programs designed to increase renewable energy, increase energy efficiency and reduce global warming:

- Spending about \$700 million per year by the IOUs to achieve energy efficiency targets set by the CPUC. Approximately \$300 million per year is funded by distribution customers (including customers of IOUs, ESPs and CSAs) through the public goods charge, and approximately \$400 million is funded solely by bundled IOU ratepayers.
- Contracting restrictions pursuant to the statutory emissions performance standard, which statutorily (AB 1368) apply to all LSEs in California.
- Bundled IOU ratepayers have subsidized renewable distributed generation by contributing over \$400 million in 2001-2006 in incentives through the self-generation incentive program (SGIP).
- Spending of about \$135 million per year for renewable energy, including the PIER program, emerging renewable program and above-market costs of long-term renewable contracts, collected through the public goods charge.
- Bundled utility ratepayers will subsidize rooftop solar photovoltaic with up to three billion dollars over the next ten years through the California Solar Initiative program.
- Funding of potentially up to \$250 million over ten years for the statutory solar thermal water heating program;

- Potential funding of up to \$600 million over ten years for the proposed California Research Initiative.
- Investments of about four billion dollars by the regulated IOUs (approved for PG&E and SDG&E, application pending for SCE) for advanced metering infrastructure ostensibly designed to increase the potential for demand response through dynamic pricing tariffs.
- Untold amounts of transmission investment that may be necessary to bring renewable resources on-line.

While all IOU distribution customers pay the public goods charge, several of the programs outlined above are funded strictly through rates paid by bundled customers of the regulated IOUs. Many of the programs – energy efficiency, SGIP, the Solar Initiative, the Climate Research Center – are designed to produce public benefits or have important spillover effects that will reduce GHG emissions not just in the service territories of the IOUs. The result is that California is using one of the most regressive forms of taxation – utility bills – to fund programs that benefit all citizens.

Funding for these programs has contributed to the upward spiral of rates for bundled customers of the IOUs.

The Commission should the following measures to ensure that auction revenues from the electricity and gas sector offset existing ratepayer funding for carbon emissions reduction:

- There should be a cost-effectiveness comparison of the various existing “GHG” programs, which arguably is not done in the current program overlay.

- Auction proceeds should be used to replace the portion of the public goods charge collected for energy efficiency and renewable energy programs.
- Auction proceeds should be used to fund the statutorily mandated California Solar Initiative, SGIP program and solar thermal heating program, with proceeds equitably allocated to those entities responsible for implementing these programs.

PG&E, in its August 2007 comments, recommended that allowances be allocated to LSEs, and an independent agency would auction the allowances to generators and first sellers. The revenues from the auction would be distributed for the benefit of LSE customers. As TURN understands this proposal, it is tantamount to providing for a separate auction for the electric sector followed by an administrative allocation of the proceeds. The auction would serve the role of setting the ‘price’ for an emissions allowance, but the net effect on LSEs could be tantamount to a free administrative allocation, if all the proceeds are distributed to the LSEs pursuant to an administratively determined formula.

TURN agrees that such a mechanism might best protect utility ratepayers from any rate increases. The administrative allocation of revenues could return funds to LSEs or could be tied to some requirements to fund renewables, energy efficiency or other GHG reduction programs. TURN appreciates that the potential differences in incentives for regulated IOUs might warrant different treatment of the electric sector in the allocation process. TURN looks forward to exploring this issue further.

Low-income people are most burdened by rising energy prices while generating fewer carbon emissions, and should be compensated or protected through their rates.

Revenues should be directed first at underserved customer classes, who both bear the brunt of increased electric and natural gas prices, but are also least able to change their behavior.¹³

If auction proceeds from all sectors are distributed by the legislature for purposes furthering GHG reduction, a variety of other interesting proposals have been put forward. These include “CarbonShare” which provide equal per capita allocations from auction to all citizens. A rate structure will have to be maintained which continues to promote conservation. To the extent that the program includes transportation fuels, an earned income tax credit can mitigate the effects of higher gasoline prices on lower-income people. Many parties, including the PUC, have spoken about funding research and development costs of transition to a lower-carbon economy, much of which should be borne by the auction of transportation fuels, not just electricity. The open question is whether these expenditures directly and fairly address the costs and burdens of change, which ultimately is a function of the political process.

Q9: Administrative Structure for Auction: It is our understanding, based upon discussions with agencies involved in the implementation of RGGI and with emissions brokers who are planning to participate in this market, that the RGGI states have a strong preference to NOT conduct the allowance auction themselves. States have many reasons for expressing this preference, including lack of experience in financial transactions,

¹³ Many low income residents live in rental units and do not own their appliances. Landlords often purchase the least expensive product since they are not paying the electric or natural gas bills. We also recommend that the Commission consider sponsoring legislation requiring landlords to purchase “EnergyStar” or better appliances.

concern about high administrative expenses (this derives from their experience assessing and collecting Title V emissions fees), lack of clear statutory authority, or simple disinterest. These experiences have informed the design of the RGGI auction, which is intended to be administered by a third-party, and include allowances from multiple states in each auction. Emissions brokers express concern over transparency and market power. There is general agreement that hedge funds, banks and other financial institutions will be very active participants. The value of allowances to be auctioned, assuming that all ten states auction 100% of their allowances each year, will at most be \$1 billion, a sum readily available to most serious Wall Street firms.

In the electricity area, some states, such as New Jersey, have had success procuring supplies through auctions, and firms such as World Energy have built a business model that relies on procuring significant purchases of renewable energy for clients at or near the same price as conventional electricity. For California then, the question of whether the state operates the auction or defers to a third-party administrator is linked to how the revenues are going to be used and how assured the state is that the revenues raised will be used for their intended purposes.

Energy efficiency funds have been raided in some states over the past several years¹⁴, and this has driven concerns among RGGI affected sources that the auction revenues may be diverted for some other purpose unrelated to the program goals. This highlights the need for the CPUC to say early and often that auction revenues must be used for GHG mitigation-related measures. It may be easier for California to exercise appropriate oversight to a third-party than to take enforcement action against one of its

¹⁴ Connecticut, Illinois, Massachusetts, Rhode Island and Wisconsin

own agencies. A third-party may also be less subject to political influence, should a change in administration occur. A third-party may also make it easier to transfer funds to designated sources, and to adjust the amount of funds expended for the stated purpose each year. The question of who should administer the funds therefore becomes more of a political, rather than a technical or structural, question to answer.

Administrative Allocation of Allowances

Q10-20. The question of administrative allocation does not apply in the context of a 100% auction under FS. Under LB regulation, the question of auctioning versus is complicated by the differing financial incentives that apply to various LSEs. The regulated IOUs can pass through allowance costs. The situation for other LSEs may be different. Under LB regulation, it is not clear whether there is any need for an auction, since the cap is essentially analogous to an administrative allocation.

An administrative allocation of allowances is politically complicated. Creating a market through free allocations is nearly an oxymoron—it becomes a politically administered market, precisely what a market system is designed to avoid. So to the extent that dislocations or problems occur, it is the revenue side which requires more substantial exploration and discussion. The legislature can essentially allocate allowance proceeds by distributing revenues.

Revenue allocation should be guided by equity principles. Parties which have expended costs in the past for reducing emissions should not be penalized. On the other hand, subsidies should be directed to those who can most readily reduce emissions. The optimal way of doing this would be by aggregating all existing subsidies by LSE

ratepayers in the electric sector and channeling them in the most cost effective manner toward carbon reduction. Such a redirection of funds would require legislative action.

Allowance Allocation under Deliverer/First Seller Point of Regulation

Q21-22. Our comments on 100% auction are based on a first-seller approach. Should that approach be used, there can be little doubt that 100% auction, as we have noted, based on assumptions of equitable distribution of revenue, is the preferred approach.

October 31, 2007

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Larry Wong, certify under penalty of perjury under the laws of the State of California that the following is true and correct:

On October 31, 2007 I served the attached:

**COMMENTS OF TURN ON EMISSIONS ALLOWANCE DISTRIBUTION
UNDER POTENTIAL CAP AND TRADE REGULATION**

on all eligible parties on the attached lists to **R.06-04-009**, by sending said document by electronic mail to each of the parties via electronic mail, as reflected on the attached Service List.

Executed this October 31, 2007, at San Francisco, California.

/S/

Larry Wong

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